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The case against a revenue-neutral carbon tax

I'm a fan of carbon taxes, but increasingly I see the term "revenue-neutral" attached to it. Where I live, in BC, we have perhaps the most prominent example of a revenue-neutral carbon tax, and carbon tax advocates have come to promoting the BC model to other jurisdictions, such as Ontario, who are contemplating their own carbon tax. This includes the new EcoFiscal Commission, which endorses a naive view of markets – the magic of free markets is alive and well, and if only we could put a price on carbon to change marketplace incentives, all will be well.

Revenue neutrality is a bug of BC's carbon tax framework, not a feature. Here's why.

First of all, while economists love the idea, most ordinary people simply don't get it. Revenue neutral is the idea that all carbon tax revenues must flow back out the door as other tax cuts (typically income tax) but also could be in the form of tax credits or a fixed dividend. In some cases, people do not trust that this is going to happen as promised. In BC, they would be right, as 2/3 of carbon tax revenues have been used to support corporate income tax cuts.

More importantly, while people may not like paying taxes, when they do they want to see that money build stuff. That is how people understand taxes. And dang it, we need to build a lot of stuff to get us off of fossil fuels: walkable and bike-able communities, public transit, energy-efficient buildings, zero waste systems, renewable energy, as well as forest conservation and stewardship measures.

None of these things can effectively be bought with a tax cut. Indeed, the ability of many actors to respond to a carbon price is constrained by their circumstances: if you live in the suburbs you don't really have an option but to keep driving; if you are a renter you don't have agency over energy efficiency investments; and even if you are a concerned home owner, the area of energy efficiency is plagued by market failures in information, such that profitable investments often go unrealized in favour of the status quo.

Big picture, climate action requires that we act together to make systemic changes and infrastructure investments to reduce our emissions. Carbon pricing is part of the answer, but regulations and public investment are also needed. Too many carbon tax advocates tend to pit carbon taxes against those other measures.

The case for revenue neutral is often made on the grounds that people won't support it otherwise. In response, I note recent comments from Washington State Governor Jay Inslee, as the state looks at a more aggressive climate action plan:

My conclusion is that a revenue-neutral proposal does not give you additional support either in the legislature or in the public. It actually has *diminished* support. That's from a guy who's been in this business for 22 years, and both won and lost elections. It's important to listen to people, and I've listened to people and that's the conclusion that I've reached.

Revenue-neutral advocates also make unsupported claims about the benefits of tax cuts, especially personal income tax cuts. In particular, the claim that PIT cuts will be beneficial due to disincentives to work from taxes is just plain wrong. Even in economic theory the impact is ambiguous (there are both income and substitution effects in response to a tax change). People cannot easily alter their hours of work in response to PIT rates, and studies show that the impact of PIT on work effort is basically zero. In fact the top 1% facing the highest top marginal tax rates tend to work longer hours.

If you want to maximize the economic benefit of those carbon tax revenues, it is widely known that public spending/investment is a better approach. Multipliers for public investment are much higher than for tax cuts. That is, they have a bigger impact on employment and provide a bigger boost to GDP. So to the extent that carbon taxes are part of the answer, they are more effective if revenues are used to support climate action initiatives, economically and in terms of affecting the change we want.

Some perspective on effectiveness also comes from the collapse of market prices for oil, a price impact which far outweighs any carbon pricing on offer. Historically, price swings due to market forces swamp carbon pricing efforts. Vancouver is a good example, even on a weekly basis as the price of gas fluctuates by more than the amount of the carbon tax. If we were to boost gas prices back to levels of June 2014, before the price crash, we'd be looking at a carbon tax of more than $200 per tonne.

Finally, revenue neutrality is bad public finance. PIT funds important public services that we will need well after we solve our carbon problem. We need stable revenue bases (income and sales being the main ones) to support a vibrant public sector. This is often neglected by economists whose models start with a hypothetically perfect market without government, then crudely "prove" that government interventions make things worse by deviating from that fantasy equilibrium. This includes results from computable general equilibrium (CGE) models, which are presented as if they are offering empirical data when they are really just taking bad theory and putting numbers to it.

So let's say yes to carbon taxes, but no to BC's revenue neutral approach. Supporters of the BC model also tend to gloss over the BC government's obsession with natural gas exports, which if successful would pump hundreds of millions of tonnes of CO_2 into the air each year.

If we are to stay below 2 degrees of global warming, major constraints on carbon will be needed, and a large portion of our fossil fuel reserves left in the ground. So the appropriate question is what is a carbon pricing trajectory consistent with that, or consistent with Canada's plausible share of global carbon budget (as recommended by the IPCC).

Income transfers do need to be part of the system, because carbon taxes are regressive – they have a bigger hit on the incomes of low-income households than high-income households. So I support an enhanced credit that would go to low- to middle-income households. A flat dividend approach is favoured by some, but I like Canada's experience with transfers like Old Age Security and Child Tax Benefits that reach a high percentage of households, but target the most income to the most in need.

The naive markets view has come up with some catchy slogans (e.g. "tax what you burn, not what you earn"), I'll give them that. But their approach is too rooted in neoclassical economics and is biased towards individual- or firm-level decision making in response to price changes. We can have fair and effective carbon pricing, but that means giving up on revenue neutrality (for more on the BC carbon tax, see this report).

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